

25X1

DATE 11-5-87 FILEDOC NO EUR M 87-20123OIR 3P & PD 1

Central Intelligence Agency



Washington D.C. 20505

FILE

EUR
RECORD COPY

DIRECTORATE OF INTELLIGENCE

14 September 1987

Poland's Economic Performance and Policy:
Implications for the United States

Summary

Warsaw's mishmash of economic policy under the legislated, but largely unimplemented, first stage of reforms has produced only a slow recovery from the economic crisis of the early 1980s. Even after four years of modest growth, per capita income remains ten percent less than a decade ago, and urban workers have experienced only marginal improvements in living standards. Warsaw's hard currency debt problem has steadily worsened: the \$1.1 billion projected hard currency trade surplus for 1987 will cover only about one quarter of Poland's obligations on its \$35 billion debt. Repayment of Poland's ruble debt to the USSR has been deferred until after 1990, but Poland succeeded in cutting its trade deficit with the USSR by about 40 percent last year through increases in exports. Further gains seem likely this year.

25X1

This memorandum was prepared by Office of European Analysis. It was requested by Col. Sam Watson, Office of the Vice President. Comments and questions are welcome and should be addressed to Chief, East European Division

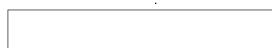
25X1

25X1

25X1

25X1

25X1



25X1

25X1

[redacted]

Poland has to undertake major economic reforms if it is going to achieve more than marginal improvements in growth and living standards while making a dent in its foreign debt. Warsaw's much touted "second stage" of economic reforms is now under active discussion, but Jaruzelski's ability and willingness to effect real change are highly suspect. Bureaucratic inertia and regime concern over possible worker unrest continue to be considerable political obstacles to implementation of effective economic policies. [redacted]

25X1

In the meantime, Warsaw is pushing hard for debt reschedulings with Western commercial and official creditors, which Jaruzelski hopes will pave the way for new credits from the International Monetary Fund. Warsaw considers such support essential to Poland's eventual economic recovery. The United States has received little gratitude for lifting sanctions earlier this year and is being pressed strongly by Warsaw for help with the IMF, to increase imports from Poland, and to invest in joint ventures; Poland may also dangle offers to buy or lease US-built commercial aircraft. The pace of discussions has also quickened in official bilateral cooperation in science and technology, especially in environmental protection. Other areas of considerable potential for expanded cooperation include nuclear safety and health and human services. [redacted]

25X1

Poland's Struggling Economy

The Polish economy remains afflicted with serious economic problems as it slowly recovers from the crisis of the early 1980s. GNP growth of 2.9 percent in 1986--down slightly from annual average gains of 3.2 percent in 1982-1985--has brought total output back to roughly the 1978 peak; however, per capita income is still 10 percent below the level of a decade ago (see table 1). Warsaw is struggling with inflation, shortages of key industrial and consumer goods, declining industrial productivity, inadequate earnings to service its \$35 billion foreign debt, and Soviet demands for more exports. Prospects for improvement are sharply limited by continuing energy constraints, inadequate investment resources, and a lack of incentives for improving poor worker morale. [redacted]

25X1

The economic rebound has been much stronger in agriculture than in industry. Agricultural output is now nearly 26 percent above the 1980 level. Generally good weather and somewhat more lenient policies for private farmers have produced record or near record harvests for the past three years. By contrast, industrial output is returning only now to the 1980 level. Manufacturing remains hampered by aging capital stock, shortages of inputs and spare parts, and lack of improvements in energy efficiency. [redacted]

25X1

The Polish population, especially urban workers, have experienced only marginal improvements at best in living standards over the past four years. Although wage increases last year stayed slightly ahead of the 18 percent rise in the cost of living, consumers continue to contend with shortages and poor quality goods, while meat and

25X1

25X1

=====

Table 1
Economic Indicators

Indicator	1986/1985 Percent Increase	1986/1982 Percent Increase	1986/1978 Percent Increase/ Decrease
Gross National Product	2.9%	13.2%	1.6%
National Income per capita	4.0%	18.0%	- 10.0%
State Industry	2.5%	14.5%	- 4.4%
Agriculture	4.7%	15.5%	14.8%
Construction	1.8%	20.0%	- 20.0%
Exports (hard currency)	4.6%	NA	7.2%
Imports (hard currency)	3.6%	NA	- 10.1%

=====

gasoline are still rationed. The lack of housing is also a serious aggravation for the population, leading Embassy Warsaw to term the poor quality and inadequate supply of housing "disastrous".

25X1

External Problems

Poland's hard currency trade performance remains inadequate to meet both obligations on its foreign debt and import needs for modernization of industry. Exports last year rose almost \$460 million to \$6.2 billion, but export gains continue to fall short of Warsaw's expectations because of the poor quality of Polish goods, low world commodity prices, and growing competition from the newly industrializing countries of Asia. Last year imports rose about as much as exports--\$458 million--to total \$5.1 billion. Imports were higher than Warsaw planned, but shortages of needed Western equipment, parts and materials continued to idle a substantial portion of Poland's industrial capacity; inadequate supplies of imported feed grains reduced livestock holdings. Hard currency trade performance appears somewhat improved in the first half of 1987, with exports to the West up almost eleven percent.

25X1

25X1

25X1

Last year's \$1.1 billion trade surplus--almost identical to the 1985 result--fell \$1.3 billion short of the amount needed to make payments on Poland's foreign debt. The arrears boosted Poland's debt to \$35.3 billion by mid-1987. The growth of the debt shows no sign of decrease as this year's projected trade surplus remains near \$1.1 billion--leaving Poland \$2.8 billion short on its obligations. []

25X1

Poland's trade deficit with the USSR continued in 1986, but showed some improvement. Exports rose faster than imports, cutting the trade deficit from about 930 million rubles in 1985 down to 680 million in 1986. Moreover, Poland announced in July a trade surplus with the Soviet bloc for first-half 1987, its first in years: .

- Although the Soviet Union has forgiven principal payments on its loans to Poland until after 1990, it is pressing Warsaw to improve its trade balance and to forge closer economic links with the USSR, particularly through joint ventures that improve Soviet factories' access to industrial inputs.
- Poland, however, remains wary of commitments that may hinder or preclude much-desired joint ventures with the West. Moreover, most Polish factories are skeptical about the advantages of joint ventures with the USSR, given the price and foreign exchange distortions within the Soviet bloc. []

25X1

Actions Needed to Improve Performance

In our judgment, Poland probably cannot sustain economic growth of more than 1 to 2 percent annually, improve living standards, and make inroads on its debt, without a major overhaul of its economy. Needed actions include:

- Eliminating subsidies to inefficient enterprises, which dominate heavy industry in particular;
- Providing more resources to sectors such as light industry and agriculture, in which Poland may have a competitive advantage, and which could improve consumer supplies without large increases in imports;
- Putting more resources into housing would also help boost popular morale and facilitate movement of workers to more competitive industries;
- Linking wage increases to productivity gains and introducing stronger incentives for exports;
- Reducing the central bureaucracy and giving producers greater authority to determine uses of inputs, make decisions on product lines, and retain hard currency for exports;
- Eliminating price controls and subsidies to promote more efficient use of resources and to increase production of goods in demand;

25X1

- [redacted]
- Increasing the power of banks to extend credit and declare enterprises bankrupt.
- [redacted]

The Jaruzelski regime now has under discussion its so-called "second stage" of economic reform which, on paper, addresses many of these needs. This second stage is really a renewed effort to carry out reforms legislated in 1981 that were not implemented or which were reversed in subsequent years. Jaruzelski has attempted to give new impetus to the reform effort by naming a leading economist and reform advocate, Zdislaw Sadowski, to deputy premier. Sadowski has been stumping the country to win support for the new program. At the same time, Warsaw has been trying to convince the IMF, World Bank, Western governments and commercial banks of its rekindled commitment to reform in an effort to win more financial assistance. [redacted]

Despite his regime's new zeal for reform, we are skeptical that Jaruzelski's program can be implemented. Probably the most formidable obstacle is the bureaucracy itself. Planners and line ministries have successfully resisted Jaruzelski's first efforts at reform--as well as the programs of two previous regimes--and we have seen few signs that their influence has weakened:

- Poland's Planning Commission is loath to surrender or share its present authority over economic decisionmaking.
- Poland's industrial ministries also balk at delegating authority to their constituent enterprises and are able to maintain high investment expenditures in their sectors despite the leadership's effort to reduce and reallocate construction funds. [redacted]

Although Gorbachev's new policies in the Soviet Union have undercut the ideological support for centralized decisionmaking, the Planning Commission and the industrial ministries in Poland remain powerful. They apparently had enough power this summer to fill a newly-proposed task force on reform implementation largely with their own representatives. According to press reports, Jaruzelski already is concerned about the content of his reform package, and is trying to enhance Sadowski's role in the review of the reform program and reduce the bureaucracy's influence. [redacted]

We also are skeptical of the government's ability to carry out its intended wage and price policies. Concern over worker unrest and lack of financial discipline in enterprises thwarted efforts under the first stage of reforms to tie wages to productivity and to reduce subsidies. The same constraints probably will face measures now being discussed for the second stage. [redacted]

Even now Warsaw is struggling with wage growth exceeding 19 percent, despite a government-imposed 12 percent ceiling, as subsidized factories raise wages--under threat of labor unrest--in response to increased consumer goods prices regardless of the impact on enterprise profits. About 1,000 enterprises experiencing production declines this year gave their workers substantial raises. In response, Warsaw recently announced its intention to "strictly implement" a 500 percent tax on factory-initiated wage

[redacted] 25X1

increases in excess of worker productivity gains. The outcome of this action will be a test of the revitalized reform's effort to impose greater financial discipline on enterprise wage policies. [redacted] 25X1

Even the leadership of Poland's new officially sanctioned unions--which the regime hopes will win workers back from Solidarity--appears ready to provide only qualified support at best for the second stage of reforms. [redacted] 25X1

[redacted] 25X1

Other reform planks, such as expanding the role of private enterprise and reassessing capital construction projects, also face strong opposition. Jaruzelski apparently agrees with Gorbachev that bureaucracy and inflexible central planning are at the root of many economic problems in socialist countries, and he would like to expand privatization. Poland at present has 450,000 private enterprises; most are farms that on the average employ less than two people, but some also provide food processing services and produce goods ranging from electronics equipment to car parts. Privatization faces considerable opposition within the government, however, especially by the industrial ministries whose smaller factories are vulnerable to competition. Furthermore, the unions also oppose expanding private enterprise, arguing that the private sector is a source of large, illegally earned fortunes that should be more heavily taxed. [redacted] 25X1

Warsaw desperately needs to suspend or cancel a number of construction projects and devote resources to priority needs in infrastructure and light industry. But plans to redirect investment spending face strong resistance; support--both from the ministries and local authorities--is strong for many projects already underway that are far behind schedule, technologically obsolete, or in the case of heavy industry, redundant. Opposition to cutting these projects will continue to plague economic policymaking, even with a serious reform effort. [redacted] 25X1

Getting Help From Abroad

In tandem with its reform initiative, Warsaw is intensifying efforts to attract foreign loans and investment. Jaruzelski wants new loans from the West that would enable Poland to reactivate and modernize currently idle industrial capacity through increased imports of technology, equipment, and materials from the West. To get new loans--Poland has received only token amounts of new credits since 1981--Warsaw must reschedule existing private and official debts and implement a standby program negotiated with the International Monetary Fund (see box); a standby gives Poland access to IMF credit, but more importantly it places restrictions on Polish economic policy that, if adhered to, make Poland a more attractive credit risk to other commercial and official creditors:

25X1

- Poland's commercial creditors initialled an agreement in July that reschedules the debt coming due in 1988-1993 at a lower interest rate, in exchange for some payment of principal; the agreement also requires Poland to meet IMF requirements for a standby agreement before the 1991-1993 portion of the rescheduling can be implemented. []

25X1

Standby Agreements with the IMF

An IMF standby agreement guarantees a country access to a specified amount of resources from the IMF over a period of one to four years, provided the country agrees to certain conditions spelled out in the agreement. These conditions vary from one agreement to another, and are more stringent for heavier borrowers. The IMF may require the country requesting a standby to change its policies or introduce new measures in such areas as taxation, government budget, exchange rate controls, external debt management, or treatment of foreign investment. []

25X1

The requesting country often does not use the IMF resources made available. The main benefit of the agreement is that the country's cooperation with the IMF reduces the risk of lending to that country for commercial banks or prospective official creditors. We expect Poland would probably use some and perhaps all of the IMF resources made available--its cost of borrowing is less than commercial and official alternatives--but Warsaw is probably more interested in using its cooperation with the IMF to improve its standing with other creditors. []

25X1

- Following progress in rescheduling commercial debt, Warsaw is seeking to reschedule debts to official creditors--referred to as the Paris Club. The Paris Club proposed a rescheduling agreement in July, but Poland has yet to officially respond to the proposal, which also stipulates that Poland must arrange an IMF standby, and must pay all of the \$800 million in arrears on its 1981 official debt rescheduling. Poland claims it can only pay part of the 1981 debt. []
- Only preliminary discussions have taken place so far on the IMF standby program demanded by both commercial and official creditors. Such an agreement could yield Warsaw as much as \$1 billion in new IMF credits over the next few years, but more importantly, Poland's cooperation with the IMF could attract even more in official and commercial credits. The price, however--one we think Poland is unlikely to pay--is an IMF-approved set of austerity measures designed to improve Poland's economic health by reducing consumption, investment, and imports, while promoting exports. Polish officials have indicated that they fear such a program would be difficult to implement, and would risk renewed instability. []

25X1

25X1

25X1

25X1

25X1

[]

Jaruzelski appears to have hit upon a tactical move to evade responsibility for imposing the greater austerity on the populace that an IMF standby would require. In July, he announced that he would submit an IMF program to public referendum, an unprecedented move in post-war Poland. This would facilitate scapegoating the IMF later if such a painful program were implemented with popular approval. In the more likely event of a popular veto, Jaruzelski could argue to Western creditors that they and the IMF must be flexible in formulating Poland's repayment schedules and credit terms, in order to let Warsaw escape its foreign debt dilemma while avoiding internal unrest. []

25X1

25X1

Meanwhile, Poland's ongoing legislative review of economic reforms may already be inching Warsaw closer to new credits from the World Bank. The Bank announced in July that the reform measures proposed by the Polish government could make Warsaw eligible for its first World Bank loans. According to press reports, preparations are underway in the Bank to grant Poland loans in the fiscal year that ends on 30 June 1988. Western governments would probably block World Bank loans to Poland next year if Warsaw remains in arrears on official credits and fails to obtain an IMF standby agreement. But neither an IMF program nor an absence of arrears is a Bank pre-requisite, and precedent exists in the case of Peru for the World Bank to grant loans to countries in such financial straits. []

25X1

What Poland Wants From the United States

Poland's efforts to obtain financial assistance and increased export opportunities will continue to figure prominently in its dealings with the United States. The restoration of most-favored-nation (MFN) status for Polish exports to the United States last March prompted not gratitude but rather criticism that the trade sanctions had badly hurt Poland's economy and its ability to repay debts to the West. Direct demands for compensation from the United States for economic losses resulting from the martial law sanctions have declined, but the idea that the United States should compensate Poland in some manner underlies Warsaw's negotiating stance on economic relations with the United States. []

25X1

Warsaw believes that the United States will determine the Paris Club's rescheduling terms and policy conditions attached to an IMF standby agreement. It already has complained about alleged US efforts to hinder its efforts with both organizations. We expect Warsaw to step up its pleas to Washington for a more understanding and cooperative stance on financial relief and IMF assistance for Poland. []

25X1

While seeking new foreign loans, Poland will further its efforts to acquire technology and equipment through joint ventures with US firms and through government-to-government cooperation. Warsaw's new joint venture law has yielded only a few agreements so far, but one of the first--announced only this July--is with a US firm:

25X1

25X1

- Marriott International is cooperating with the Polish airline Lot to complete a partially-built hotel and conference center that would be Poland's largest hotel, a 1000-bed unit near the railway station in downtown Warsaw.
- The US Consulate in Krakow reports that city officials there are eager to gain US cooperation on a planned airport-hotel complex.
- US firms, however, continue to face difficulties identifying cooperation projects with good profit potential, as well as problems in repatriating profits in hard currency. [redacted]

25X1

We believe the Poles will push for bilateral government cooperation, particularly in the following areas:

- **Nuclear safety.** Poland's pressing energy needs, its problems in constructing its first nuclear plant, and its distrust of Soviet technology in the wake of Chernobyl all enhance Polish interest in expanding nuclear cooperation with the West.
- **Health.** The Polish Ministry of Health is highly interested in bilateral cooperation with the US Department of Health and Human Services; over thirty potential cooperation projects have been identified.
- **Environmental protection.** Poland will make good use of the newly signed agreement on environmental protection; Embassy Warsaw believes Poland's ecological problems are the worst in Europe. The Environmental Protection Agency's delegation to Poland last year, which focused on air and water pollution control, was extremely well-received. Warsaw is interested in cost-effective pollution control technology that could be readily assimilated. [redacted]
- **Civil Aviation.** Although no significant problems exist in the present civil air agreement with Poland, Warsaw is eager to negotiate a new, longer-term agreement that it feels will make current routes more permanent and enable the Polish airline Lot to make better long-run decisions concerning the purchase of new aircraft. This summer Lot has leased a DC-8 from a US firm and has discussed aircraft leases and purchases with Boeing prior to discussions with the Soviets and other Western suppliers. [redacted]

25X1

25X1

Movement in any of these areas would help Poland meet pressing needs and improve the US-Poland relationship. Environmental and health programs would probably be the most cost effective US aid to Poland. Such assistance would be relatively inexpensive, yet highly visible to the average citizen. Environmental assistance would also offer an opportunity for US business in areas of non-sensitive technologies. At the same time, although aircraft sales probably would raise technology issues for the US government, Warsaw's purchase of US aircraft not only would mean commercial sales, but a gain for US public diplomacy. [redacted]

25X1

25X1

[REDACTED]

25X1

While Warsaw is highly interested in cooperation agreements, Poland's need for new credits to modernize and expand industry is more fundamental to economic recovery and less easy to satisfy. The ability of the Polish government to implement the new reforms is a prerequisite that must be demonstrated before Poland can expect increased cooperation and funding from the West. In the absence of economic reforms, new credits would be less effective, perhaps even counterproductive, in Warsaw's efforts to bring Poland out of its economic and financial dilemma. [REDACTED]

25X1

[REDACTED]

25X1

SUBJECT: Poland's Economic Performance and Policy: Implications for the
United States

Distribution:

Orig - Vice President

5 - IMC/CB

1 - D/EURA

2 - EURA/Production Staff

1 - EURA/EE/NE

DDI/EURA/EE/NE/[] (14Sep87)

25X1